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Remarks

Remarks of Chairman Gary Gensler, Panel to Discuss Financial Reform, Columbia University, New York, N.Y.

April 12, 2010

Good evening. I thank Professor Joseph Stiglitz and Columbia University's Committee on Global Thought for inviting me here today. I am honored to be on a panel with Professor Stiglitz, former Securities and Exchange Commission Chairman Arthur Levitt, and Phil Angelides, who is currently heading up the Financial Crisis Inquiry Commission.

The focus of this panel spans numerous issues related to financial reform, but, as the head of the federal agency that oversees the regulated derivatives markets – called futures markets – I am going to swim in my lane tonight. I will focus on why we must bring comprehensive regulatory reform to the unregulated derivatives markets, called the over-the-counter (OTC) derivatives markets. I will do this in the context of some key reasons that have been suggested over the years for not regulating these markets.

Derivatives have been around in the U. S. since the Civil War. They were first used by grain merchants and farmers to hedge against future changes in prices in corn, wheat and soybeans. They were later used to hedge the price risk of energy products, metals and financial returns. These derivatives – traded on exchanges – are called futures.

A new type of derivatives, called over-the-counter derivatives or swaps started in the 1980s. In contrast to the regulated futures marketplace, OTC derivatives generally are not traded on centralized exchanges and have thus far been largely unregulated.

Derivatives markets – regulated futures and unregulated OTC derivatives – form an important part of our financial markets. Along with securities markets, they function to help businesses and the public invest their savings, raise capital, borrow money and manage risk.

Comprehensive federal regulation was brought to all of the securities and futures markets after the last great financial crisis in the 1930s. Thus, the securities and futures markets have benefited from regulation that ensures a level playing field for market participants. Regulation helps to ensure that markets are fair and orderly and free from fraud and manipulation. Regulation promotes transparency and lowers risk to market participants, the economy and the public. This builds confidence and credibility in the marketplace, promoting efficient financial markets that ultimately benefit businesses and job creation.

Things began to change in 1981, though, with the first OTC derivative transaction.

And now, nearly thirty years after they were developed, OTC derivatives remain unregulated, which is in stark contrast with the other major parts of our financial markets – the securities and futures markets.

OTC derivatives were at the center of the 2008 financial crisis. They added leverage to the financial system with more risk being backed up by less capital. Taxpayers bailed out AIG with $180 billion when that company's ineffectively regulated $2 trillion derivatives portfolio nearly brought down the financial system – that means that every person in this room has $600 in AIG. Over-the-counter derivatives – initially developed to help manage and lower risk – actually concentrated and heightened risk in the economy and to the public.

There have been many reasons put forth over the years about why over-the-counter derivatives should not be regulated. I would like to touch upon five such reasons.

First, it was claimed that the derivatives market was an institutional marketplace, with "sophisticated" banks, businesses, pension plans and municipal governments who did not need the same types of protections that the broader public needs when investing in the securities or futures markets. Derivatives, however, are complex financial instruments, and even the most "sophisticated" parties would benefit from protections in the marketplace. Markets, even amongst institutions, work better when transparency and market integrity are promoted, protecting against fraud, manipulation and other abuses. Further, the institutions that use OTC derivatives represent consumers, pensioners and workers, and their risk can be transferred to the American public in the form of taxpayer-funded bailouts.

Second, it was claimed that over-the-counter derivatives did not need regulation because the institutions dealing them were already regulated. That, however, proved to be a faulty assumption. The banks that deal derivatives have not been expressly regulated for their derivatives business. AIG is another example of an ineffectively regulated derivatives dealer. Though it was a regulated insurance company, AIG's derivatives affiliate was not subject to any meaningful regulation by market regulators. Just because a bank, an insurance company or an oil company may be regulated for one line of business does not mean that it also was regulated for all of its risky endeavors. Financial reform, therefore, must bring comprehensive regulation to the banks and other entities that deal derivatives.

Third, it was claimed that large, sophisticated financial institutions dealing over-the-counter derivatives, as well as their counterparties, were so expert and self-interested that the markets would discipline themselves. The risks associated with derivatives are so significant, however, that reliance on market discipline alone – particularly in such an opaque market – proved disastrous. Further, after the financial bailouts of 2008, many in the markets assume that dealers – so big, concentrated and interconnected – would be bailed out again if another crisis strikes. This creates a significant moral hazard – a system where "heads" Wall Street wins and "tails" the taxpayers may lose.

Fourth, some claimed that over-the-counter derivatives were customized and not susceptible to centralized trading or clearing. Whereas a share of a company's stock is identical to any other share of that company's stock, derivatives can be much more tailored to meet the particular needs of a particular business. But derivatives have become much more standardized over the last decade and thus more susceptible to central market structures. One Wall Street CEO recently testified that as much as 75 to 80 percent of the marketplace is standard enough to be centrally cleared.

Lastly, it was claimed that we should not regulate over-the-counter derivatives because they are not regulated in Europe or Asia. If we did, we would somehow push our markets overseas. But after the 2008 financial crisis, there is now broad consensus across borders that we must bring transparency and lower risk through regulation of the global derivatives marketplace.

So, the time has come to bring comprehensive regulation to the derivatives marketplace. We must ensure a transparent, fair and open market just as earlier generations did in the securities and futures markets. We can best accomplish this by moving all standardized over-the-counter derivatives onto regulated exchanges or similar trading platforms to improve transparency and pricing in the marketplace. We can best lower risk by fully regulating derivatives dealers and moving all standardized derivatives into clearinghouses after they are arranged. Everybody will benefit if we bring these reforms to the over-the-counter derivatives marketplace.

I worked on Wall Street for 18 years. Wall Street is not Main Street. Wall Street is primarily worried about Wall Street's interests – their shareholders, profits and compensation. That hasn't changed in the 13 years since I left the Street. But make no mistake: the financial system failed America. That's not to say that the regulatory system did not also fail – it did. But when we are fixing that regulatory system, there is a real question about the importance of satisfying Wall Street's concerns. We live in a great democracy and everyone's views should be part of this debate. The complexity of derivatives markets, though, is being used by some opponents of reform to raise all manners of issues – some legitimate – but some just to maintain the status quo. So I hope that we do not allow these arguments to inhibit reform – as they have in the past – that promotes transparency, lowers risk and adequately protects the American public.

Again, I thank Professor Stiglitz for inviting me to be on today's panel and the audience for listening.